C O N F I D E N T I A L SECTION 01 OF 03 TEL AVIV 000295

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SUBJECT: SOLID FUNDAMENTALS KEEP ISRAELI ECONOMY ON GROWTH TRACK

REF: TEL AVIV 56

Classified By: Economic Counselor William Weinstein for reasons 1.4 b and d.

Summary

¶1. (SBU) According to preliminary Central Bureau of Statistics (CBS) data released on January 1, 2006, the Israeli economy grew by 5.2 percent in 2005, and GDP per capita (USD 17,800) increased by 3.3 percent. Following growth rates of 1.7 percent in 2003 and 4.4 percent in 2004, in the initial period of stabilization and recovery after the deep recession of 2001 and 2002, the Israeli economy seems to have returned to a trend of consistent growth. The figures are also impressive in comparison with preliminary 2005 estimates of 2.7 percent growth and 2.0 percent per capita growth, respectively, in OECD countries, and 3.6 percent and 2.6 percent, respectively, in the U.S. The Israeli business sector was a major contributor, growing by 6.6 percent, up slightly from 6.3 percent in 2004. Exports and private consumption also grew strongly, as did foreign investment and the balance of payments. The Gaza disengagement and continued improvement in the security situation, the return of high-tech as a growth engine, and the continuation of the GOI's reformist economic policies all contributed to the positive picture. Regardless of the situation created by Prime Minister Sharon's illness and uncertainty regarding the upcoming elections, Israel's strong economic fundamentals remain in place for now, and it appears that the government's fiscal policies will be maintained. End Summary.

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Exports, Private Consumption, Business Sector Led Growth
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¶2. (SBU) Exports of goods and services grew by seven percent in 2005, compared to 17.4 percent in 2004, during the initial recovery from the deep recession and high-tech downturn of 2001 - 2002, when exports of goods and services declined by 11.5 percent in 2001 and 2.4 percent in 2002. Tourism revenues grew by 22.7 percent in 2005, compared to the 40 percent jump in 2004, which resulted from the dramatic increase in tourism following the winding-down of the intifada. Service and agricultural exports each increased by more than ten percent in 2005, whereas exports of goods increased by 5.6 percent. Bank Leumi, in its January 4 economic weekly, noted that exports of goods and services represented 46 percent of total GDP for the year. This is an increase from 44 percent in 2004 and 39 percent in 2003.

¶3. (C) Imports increased by 4.4 percent in 2005, compared with 11.8 percent in 2004. The jump in 2004 was influenced by three years of a cumulative decline in imports totaling more than eight percent in the 2001 - 2003 period. Aharon Blech, CBS Economist in Charge of National Accounts, told Econ that the four percent increase in imports is in line with export growth of seven percent. He did not view the slowdown in import growth negatively.

¶4. (U) Private consumption increased by four percent in 2005, compared to the 2004 figure of five percent. The largest growth in private consumption was in the purchase of clothing, footwear, and personal effects, which increased by 10.2 percent, following an increase of 5.4 percent in 2004. Consumption of consumer durables grew much more slowly than in 2004, with an increase of only 3.4 percent, compared with 14.3 percent in 2004.

¶5. (C) Business GDP grew by 6.6 percent in 2005, virtually unchanged from 2004's 6.3 percent increase. According to CBS statistics, the transportation, storage, and communications industries grew by 9.2 percent in 2005, following growth of 6.6 percent in 2004. The GDP of the wholesale, retail, restaurant, and hotel sector (grouped together as one sector) increased by 8.1 percent, compared to 6.1 percent in 2004. The GDP of the finance and business services sector increased by 6.4 percent in 2005, a continuation of 2004's 6.1 percent growth rate. Blech noted that the business sector was the most important factor in the growth picture and pointed out that business operating profits grew by more that forty to fifty percent compared to the prior year. In its macro summary, Bank Leumi also noted that there was an increase in

the output of start-up companies in 2005, following a sharp decline in the 2001 - 2003 period.

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Government Spending Increased After Two Down Years
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¶6. (C) General government expenditures increased by 2.7 percent in 2005, compared with declines of 2.3 percent in 2003 and 2.4 percent in 2004. (Note: This relates to the expenditure of the Government, the National Insurance Institute, local authorities, universities, government health providers, and institutions such as the Jewish National Fund and Jewish Agency for the purchase of goods and services and employee wages. End Note.) Noteworthy is that defense spending grew by 5.5 percent in 2005, compared with declines of 5.6 percent in 2004 and six percent in 2003. Defense imports grew by nineteen percent, compared with declines of 9.1 percent and 14.8 percent in 2004 and 2003, respectively. Blech said that the increase in defense expenditures is due both to spending on disengagement, as well as a return to spending and purchasing after two years of cutbacks in the Defense establishment.

Infrastructure Investment Ticks Up

¶7. (SBU) Fixed capital investment, which was negative from 2001 to 2004, continues to lag, although the one percent increase in 2005 indicates that the worst may be over. The most noteworthy positive trend is that investment in construction, which includes road, railway, and sewage infrastructure, increased by 3.2 percent in 2005. This compares with declines of 9.9 percent in 2004 and 1.9 percent in 2003. Dr. Yackov Sheinin, the CEO of Economic Models, has said numerous times in interviews that only investment in infrastructure will enable Israel to meet its true growth potential. Over the past year, the GOI has announced several new multi-year railway and road construction projects.

FDI, Current Account Balance Positive

¶8. (SBU) Bank of Israel statistics published on January 8 indicate that foreign investors have demonstrated increased interest in the Israeli economy during the last year. Foreign Direct Investment (FDI) totaled USD 5.7 billion, an increase of 243 percent compared with FDI of USD 1.66 billion in 2004, and exceeding the previous high of USD 5.1 billion in 2000. The FDI volume reflects, in particular, privatizations of government-owned companies, as well as foreign acquisitions of Israeli companies. Foreign investors also increased their participation in the domestic real estate market, continuing a trend in recent years. Foreign investment in real estate totaled USD 1.2 billion, compared with USD 802 million in 2004 and USD 464 million in 2003. There was also a significant inflow of portfolio investment in 2005, with foreigners purchasing USD 2.1 billion worth of shares traded on the Tel Aviv Stock Exchange (TASE), compared with USD 483 million in 2004, a stunning four-fold increase in one year alone. In addition, foreign investors purchased more than USD 500 million of bonds traded on the TASE, almost twelve times more than the USD 43 million purchased in 2004.

¶9. (C) Another positive trend signifying strength in the economy is the growth in the current account balance since 2003, moving from less that one percent growth in 2003 to 1.2 percent in 2004 and 2.1 percent in 2005. This is particularly impressive when compared to the deficit in the U.S. current account, which increased from 5.7 percent in 2004 to 6.5 percent in 2005. Blech said that the current account surplus translates into lower interest rates paid by Israeli banks to borrow money in international markets, enabling a reduction in the level of debt.

2006 Will Tell the Tale

¶10. (C) Blech was pleased with the 2005 results, and noted that the numbers may even be adjusted slightly upwards when the final results come out in March. He said that Israel's good fortune at this time is that there is improvement in the security situation and a strong upturn in high-tech, two conditions which are very important for Israel's economic performance. He also noted the connection between tourism and foreign investment, two components that contribute strongly to overall economic performance, but are very dependent on the security situation.

The Recession was very Costly

¶11. (SBU) The general consensus among economists is that

Israel's economy is very strong and that its growth potential is in the four percent to five percent range. Bank Leumi, in its January 4 summary, notes that, given this assumption, the economy lost approximately USD fifteen billion of its potential GDP during the 2001 - 2003 recessionary period. Leumi says that had Israel's economy continued to grow during that period in accordance with this assessment, GDP per capita would now be above USD 19,000, rather than USD 17,800.

All is Well, but Uncertainty Lies Ahead

¶12. (C) In light of Sharon's illness, the economic and business sector seems to be encouraged by the appointment of Finance Minister Ehud Olmert as Acting Prime Minister. It appears to believe strongly in the team of Olmert and Bank of Israel Governor Stanley Fischer as stewards of the economy is these uncertain times. The financial markets have reacted with restraint to Sharon's hospitalization in the belief that his government's overall economic policies are likely to be continued (see reftel). However, given the upcoming Palestinian and Israeli elections, one cannot ignore the turbulence that may lie ahead if things do not turn out as expected.

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